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Financial statements: What they mean: Getting the slant

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FINANCIAL STATEMENTS

→What They Mean←

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GETTING THE RIGHT SLANT

THE AVERAGE CITIZEN, before he invests a thousand dollars in a new automobile, takes time to investigate various models. The same man, however, may invest a thousand dollars in the capital stock of a corporation on a hunch, or a tip from someone whom he considers an "insider." When he sees a financial statement, he is likely to toss it aside impatiently and exclaim: "I'm not much good at figures!" or "Bookkeeping gives me a headache!" or "It's all Greek to me!"

Financial statements are not simple. They cannot be simple because they report the complex operations of modern business. But financial statements are not mysterious. They give helpful information to anyone who understands their fundamental nature and purposes and takes the trouble to study them.

This booklet does not attempt to teach accounting in 15 easy pages. It does try to give the investor the right slant on financial statements, to explain to him in non-technical language what to look for in income statements and balance-sheets and what these important financial statements mean.

Financial statements present information which every investor should have about companies to which he has entrusted his savings or to which he may entrust them in the future. The effort required to read and understand these statements is insignificant in comparison with the effort necessary to accumulate the savings.

Public Information Series

AMERICAN INSTITUTE *of* ACCOUNTANTS

13 EAST FORTY-FIRST STREET

NEW YORK, N. Y.

FINANCIAL STATEMENTS ARE SUMMARIES of accounts and records. Several types of statements have been developed and are in common use—principally the income statement, sometimes called the profit-and-loss statement, and the balance-sheet.

The *income statement* tells the investor how much profit a company made, or how much loss it sustained during a given period. It matches the costs of doing business against income earned and shows whether there are profits from which dividends can be paid.

The *balance-sheet* indicates to the investor how much money is due the company and how much money it owes, what kinds of property the company has available for use or for sale, the amount of capital stock and surplus.

Many important facts which affect a company's welfare cannot be found in its financial statements. For example: ability of the managing executives, general business prospects and the outlook for the industry as a whole, taxes and tariffs, Federal and state legislation. For such information the investor should consult annual reports of the company's officers, government bulletins, the financial press, and similar sources.

JUDGMENT AND OPINION

Many think that income statements, because they are expressed in dollars, profess to be exact calculations of profit or loss. This is not true. Nor do balance-sheets, although they are also expressed in dollars, profess to show with mathematical exactitude the financial position of a company.

"Profit" during any given period and "financial position" at any given time depend in large part upon judgment. The

presentation of various items in financial statements is based upon estimates of such factors as the probability that money due the company will be collected, the probability that the company can obtain a fair price for the goods or services which it intends to sell, the probable useful life of its buildings and machinery.

Financial statements, therefore, reflect probabilities as well as facts. Human judgment and opinion, guided by accepted rules and principles of accounting, must determine how these probabilities shall be expressed. The company's financial officers must exercise judgment in preparing financial statements and related explanations. The independent certified public accountant who examines these financial statements must express his professional opinion concerning their adequacy.

"How Much Will I Receive in Dividends?"

Every investor wants to know: "How much money will I receive in dividends?" No one, of course, can foresee the future, but the company's financial statements provide some of the information necessary to judge the possibilities intelligently.

Dividends come from earnings—either current or accumulated—although in any given year there is no necessary relation between earnings and dividends.

"X Company Earns \$1.17 Per Share." This is a typical newspaper headline. It attempts to summarize for the reader information about earnings which is presented in the company's income statement. But neither this figure, nor any other single figure, can give the investor a reliable indication of the success of the company's operations and, therefore, the probability of future dividends. Some of the questions which must be answered, before he can interpret such a headline intelligently, are the following:

Were earnings per share greater or less than during the preceding year? Have there

been any large, abnormal revenues or expenses? Has adequate allowance been made for the wearing out of the company's buildings and machinery? Have there been any significant changes in the company's accounting methods which might alter this earnings figure as compared with that for the preceding year? Have the earnings been computed in accordance with accepted accounting principles? The answers to such questions can be found in the company's financial statements, with related footnotes, and the report of the independent certified public accountant who "audits," or reviews, the statements.

"How Much Will My Shares Be Worth?"

Another question in the mind of every investor is "How much will my shares of stock be worth?" Here, again, future events will largely determine the answer, but a study of the company's financial statements is necessary as a basis for an intelligent opinion.

The value of a share of stock depends ordinarily upon the income which it may yield in dividends. The fact that a company owns a plant and other property which cost a million dollars, and has a hundred thousand shares of stock outstanding, does not mean that each share is worth ten dollars. If the company cannot operate profitably, it probably could not sell its plant and property for what it cost. If it does operate profitably, the company is unlikely to sell out its productive equipment. In neither case, can the stockholder expect to recover his proportionate share of the cost of plant and property. The value of a share of stock, therefore, depends primarily upon expected earnings, not upon what the company owns.

At any given time, of course, the price which an investor can obtain for securities is the amount which someone else is willing to pay for them. Shares of stock may sell for more or less than they appear to be worth on the basis of earnings and dividends, de-

pending partly upon current interest rates and variations in the supply of and demand for attractive investments. Their prices are affected by the operations of speculators who buy and sell securities, hoping for quick profits, as well as by the carefully estimated valuation put upon them by informed investors. A company's financial statements give no indication of the present "market value" of its stock, but they do provide the stockholder with information which helps him to judge the real worth of his shares.

THE INCOME STATEMENT

Every business, from the one-man peanut stand to the huge steel company with hundreds of thousands of stockholders and tens of thousands of employees, performs certain basic operations. It buys goods and sells goods, as the peanut man does. It makes goods and sells goods, as the steel company does, or it provides a service, as a railroad or a barber does. Income statements indicate how much money has been made or lost from these basic operations and from incidental activities.

Most income statements show income and expenses resulting from each of two distinct sources: the basic operations which the business is organized to perform, and incidental activities. The investor will naturally wish to identify these two groups of income and expenses, even though they may not be specifically labeled. It is of primary interest

NOTE.—This pamphlet discusses financial statements of manufacturing and merchandising corporations. Some types of organizations, such as insurance companies, banks, brokerage firms, railroads, public utilities and government bodies publish statements which differ somewhat from those of industrial and commercial businesses. The basic accounting principles which underlie financial statements are applicable to all types of business, but these principles themselves change with the evolutionary development of accounting, law, and business methods. This pamphlet deals with common practice of the present day and does not attempt to state ideal principles.

to him to know whether the basic operations of the company are profitable.

Income and expenses resulting from basic operations include amounts received from the sale of goods and services, costs incurred in buying or manufacturing goods which the company has sold, selling expenses, administrative expenses and wages, as well as taxes, which have become an increasingly important element in the cost of doing business. Income and expenses resulting from incidental activities include such items as interest and dividends received on securities owned by the company, interest paid on its bonds, and gain or loss resulting from the sale of investments or property.

In addition, there may be "non-recurring" income, such as gains resulting from the collection of a favorable legal judgment, and non-recurring expenses, such as losses due to hurricane, flood, fire or sabotage.

A series of income statements, covering a number of recent years, generally provides more useful information than a single statement. Marked fluctuations in earnings from year to year, and any tendency of profits to increase or decrease over a period of years, deserve special attention.

THE BALANCE-SHEET

The balance-sheet is often misinterpreted. Some misunderstanding may be due to the use of such terms as "assets," "liabilities," "surplus," and "reserves" which, in accounting, have acquired technical meanings somewhat different from the ordinary meanings of these words as they are defined in standard dictionaries.

It is commonly said that items listed under "assets" in the balance-sheet indicate what the company owns and how much is due it, while items under "liabilities" indicate how much money the company owes. The item of "surplus" is said to indicate what is left over. This is over-simplification. It is correct to say that the balance-sheet shows the "position" of a company, but even this

term needs explanation to be thoroughly understood.

What the Balance-Sheet Shows

One important fact which must be remembered is that the balance-sheet is basically historical—that is, it records the results of events which have happened. For this reason, *cost* is the primary basis of stating what the company owns. The balance-sheet does not attempt to show what the business is “worth” in the sense of an amount which might be realized if it were to be liquidated immediately—that is, if all its property were to be sold and the proceeds used to pay debts. Amounts shown in the balance-sheet are based on the assumption that the company will continue in business indefinitely.

The balance-sheet does list assets and liabilities, as those words are commonly understood, but usually it also includes under the heading of “assets,” benefits, such as “goodwill,” which ordinarily cannot be valued precisely and are therefore carried at some conventional figure, in order to show their existence. Among the other balance-sheet items are payments made in advance, and costs incurred for future benefits, which are therefore to be charged against earnings of future years. All these types of items are described briefly in the following pages.

CURRENT ASSETS

Current assets are in the form of cash on hand or in banks, and goods and claims which can be converted into cash within one year. They include marketable securities owned by the company, accounts receivable, notes receivable and “inventory” or stocks of materials and merchandise on hand.

Cost, as has been said, is the primary basis upon which assets are stated. Probable profits are not reported until actually realized and, consequently, if the market price of a current asset rises above cost, the cost figure is re-

tained in the balance-sheet. If, however, a drop in market price below cost of materials or merchandise on hand, or marketable securities, indicates that cost will probably not be recovered in full through sales, it is customary to recognize as a current asset only that portion of cost that will probably be recovered, and to report this lower figure in the balance-sheet.

From accounts receivable and notes receivable, which indicate money due the company, there is usually deducted an allowance for estimated losses because of bad debts. This deduction reduces the amount at which receivables are listed in the balance-sheet to the estimated amount which the company expects to collect.

FIXED ASSETS

Fixed assets such as land, buildings, and machinery, are usually listed in the balance-sheet at cost, an amount which may differ materially from the price which they would now command if sold. As it is assumed that the company will continue in business, there is no present intention to sell them, and therefore the amount for which they might be sold in any given year is relatively unimportant for the investor.

Over the life of an enterprise, buildings and machinery decline in usefulness owing to wearing out, or "depreciation," and the development of improved materials and methods, or "obsolescence." In the balance-sheet, an allowance for the accumulated loss in usefulness of fixed assets, owing to wearing out or obsolescence, is deducted from the amount at which those assets are carried, although sometimes only the amount remaining after deduction of depreciation is shown. Correspondingly, each year the amount of depreciation estimated to be applicable to the operations of that year is treated as a cost and deducted from earnings. This amount is either shown separately in the income statement or is included in the item "cost of goods sold."

Fixed assets which wear out, such as buildings and machinery, are sometimes spoken of as "deferred costs"—that is, costs incurred for the future production of goods to be sold. Such costs quite properly should be charged gradually against earnings over the period of years during which the goods are produced and sold. This helps to explain depreciation as a cost of production.

Under special circumstances, fixed assets are sometimes listed in balance-sheets at "appraised values"—amounts determined by appraisers, or experts in valuation. Such appraisals may result in reducing or increasing the amounts at which those fixed assets are listed. Good accounting procedure requires that if fixed assets are listed on any basis other than cost the basis be described in the balance-sheet.

INTANGIBLE ASSETS

Intangible assets, such as goodwill, patents, trademarks, copyrights and franchises, the value of which can seldom be determined accurately, may be listed in the balance-sheet, more or less arbitrarily, at one dollar or at substantial amounts, running into many thousands of dollars, based upon the cost of acquiring these intangibles or some other historical basis.

PREPAID EXPENSES AND DEFERRED CHARGES

A business often pays in advance for some of the services which it requires, for example, in the form of rent, insurance premiums or advertising expenditures. To the extent that such prepayments cover services to be rendered after the date of the balance-sheet, they are listed under the heading of assets as "prepaid expenses."

"Deferred charges" are costs which the business has incurred during the current or a previous period but which are properly chargeable against earnings of future years. A common example is "bond discount and expense." When a company issues bonds, it

sometimes receives less than the face amount of the bonds which it will ultimately have to pay. The difference between what it receives and the face amount is composed of the discount often deducted from face value in order to make the bonds saleable, compensation to investment bankers who distribute them, and legal, accounting and printing expenses.

These items which make up bond discount and expense are lumped together and charged against earnings over the period of years during which the bonds remain outstanding—that is, until the date when their face amount must be paid by the company. Any balance of bond discount and expense which has not yet been charged against earnings is listed in the balance-sheet under the heading of “assets,” although obviously this deferred charge is not an asset in the ordinary sense of that word.

LIABILITIES

Liabilities of the company, such as accounts payable and all other debts due within one year, are reported in the balance-sheet as “current liabilities.” Bonds, long-term notes, and other long-term debts are listed separately. These liabilities are listed at the face amounts of the debts. Liabilities which may arise as a result of pending lawsuits, guarantees, or other unpredictable events, are considered “contingent liabilities” and are rarely added into the total of the balance-sheet, but are usually described in footnotes.

CAPITAL STOCK

The owners of a corporation are its stockholders. The account which shows their investment in the corporation is “capital stock.” The stockholders also own, subject to restrictions, the earnings made by the company but not yet distributed. The investment of the owners and the undistributed earnings are usually shown separately in the balance-sheet. Capital stock which has

previously been issued to stockholders but since reacquired from them by the company, thereby reducing the total amount of capital stock in the hands of stockholders, is listed in the balance-sheet as "treasury stock."

SURPLUS

Surplus, like capital stock, is an "ownership" item. Obviously what the stockholders "own" (capital stock plus surplus) is represented by the amount remaining after liabilities are deducted from assets. In other words, surplus is the amount by which the sum of the assets exceeds the sum of the liabilities and capital stock.

The presence of surplus has no relation to the amount of cash available, nor does it alone justify the expectation of a dividend. The excess amount of assets over liabilities plus capital stock, indicated by surplus, may in a given case be represented by the bricks and mortar of a plant. Few successful and established corporations could pay out to stockholders the full amount of surplus shown in their balance-sheets without seriously handicapping or wrecking their business operations.

THE SURPLUS STATEMENT

Because of the importance of surplus, this item or group of items is usually analyzed in a special section of the income statement or in a separate form called the surplus statement. This statement shows the amount of surplus at the beginning of the year, amounts added during the year as income from basic operations and incidental activities, subtractions for dividends distributed from surplus, and the balance remaining in the surplus account at the end of the year.

Some companies from time to time reflect in surplus various adjustments in other accounts. Frequently, these adjustments include revisions of earnings reported for earlier years. Overestimates or underestimates of income taxes, for example, may not become apparent for a considerable period.

RESERVES

The presence of a "reserve" in a balance-sheet does not necessarily mean that the specified sum of money has been set aside for the particular purpose indicated. There are several kinds of reserves in financial statements. Deductions from assets to make allowance for bad debts or depreciation are often called reserves. In addition, there are operating reserves, often described as "provisions" for liabilities of indeterminate amounts, such as taxes, or injuries and damage claims; and surplus reserves, which are simply a part of the owners' equity which has been appropriated for such purposes as a "sinking fund" to provide for retirement of bonds when they become due.

Why Does the Balance-Sheet Balance?

The accounts from which the balance-sheet is prepared are kept in accordance with the principles of double-entry book-keeping. This is a device which helps to check the accuracy of the entries and to avoid mistakes. It accomplishes these ends by the simple expedient of entering each transaction twice—once as what is called a "debit" and once as what is called a "credit." An axiom of double-entry bookkeeping is that for every debit there must be a corresponding credit. When all the debits are added together and all the credits are added together, the totals of the two columns are naturally the same. The two sides of the balance-sheet are simply totals of debits and credits, condensed and rearranged. Therefore, the two sides *must* balance.

FOOTNOTES

Footnotes, which accompany most published financial statements, contain supplementary comments and explanations which help the investor to understand and interpret the figures. They also may describe transactions or items which, because of their indeterminate nature, cannot be included in the body of the statements. They may de-

fine unfamiliar terms, or they may explain important accounting policies, restrictions on the payment of dividends, or the basis on which items are listed in the balance-sheet.

These footnotes are an integral part of the financial statement which they accompany. Unless the investor studies and understands them, he cannot understand the items to which they refer. Footnotes are required to clarify the meaning of financial statements because accounting depends not only upon indisputable facts but also upon human interpretation and judgment.

THE AUDITOR'S REPORT

Frequently, the investor fails to realize the importance to him of the "auditor's report" which accompanies most published financial statements. Over and over again, anyone who tries to read and understand these statements is struck by the necessity for exercise of judgment in the presentation of almost every item. Inevitably, the question occurs: "Whose judgment is it?" Primarily, financial statements of corporations reflect the judgment of the management—officers and directors.

It is natural that stockholders, and officers and directors, for their own protection should desire an independent examination or "audit" of the financial statements and the underlying accounts and records by competent persons who are neither financially interested in the company nor in any way associated with its management. Such audits are usually performed by independent certified public accountants, professional men accredited by the state after satisfying educational and experience requirements and passing a technical examination. The

NOTE.—Qualifications and training of the independent certified public accountant, and some of the methods which he uses in examining a company's financial statements and records, are discussed in a pamphlet entitled "Accounting and Your Pocketbook," prepared by the American Institute of Accountants, which will be sent to any interested reader without charge.

principal stock exchanges, the Securities and Exchange Commission, and other government agencies require independent audits of companies whose securities are subject to their jurisdiction.

What the Auditor's Report Tells the Investor

After completing his audit the independent auditor prepares a "report" or "certificate" expressing his *professional opinion* as to whether these statements adequately present the position of the company and the results of its operations in accordance with generally accepted accounting principles consistently applied. The auditor's report deserves the careful attention of every investor.

FOURTEEN POINTS

(A Summary)

This pamphlet attempts briefly to acquaint the investor with a subject which is complex but of vital importance to him. An effort is made in these concluding pages to summarize the principal points here presented:

1. Financial statements are summaries of the accounts and records of an enterprise.

2. The income statement, the balance-sheet, and the surplus statement are the financial statements most important to the investor.

3. The balance-sheet reports the status of the enterprise at the end of a company's business year. The income statement reports operations—income and expenses—during the year.

4. Financial statements do not profess to show with mathematical exactitude either financial position or profit or loss of an enterprise, but are based largely upon judgment and opinion.

5. No single figure is a reliable indication of a corporation's success or probable dividends.

6. The value of a share of stock of any corporation which expects to remain in business ordinarily depends upon the earnings of the company, not upon its assets.

7. Sources of earnings—that is, whether they result from basic operations of the enterprise or incidental activities—are of primary interest to the investor.

8. The trend of earnings in recent years may be more significant than earnings reported for any single year.

9. “Assets,” “liabilities,” “surplus,” and “reserves,” as these words are used in balance-sheets, have technical meanings somewhat different from their ordinary meanings in everyday language.

10. Balance-sheets are essentially historical records. Cost, therefore, is the primary basis at which assets are stated, though current assets are usually carried at the lower of cost or market. Fixed assets are usually reported at cost. Liabilities are generally listed at the face amounts of the debts.

11. Balance-sheets usually include among the assets, in addition to cash and other property, intangible benefits such as goodwill—often listed at nominal amounts—payments made in advance and deferred costs to be charged against future earnings.

12. The presence of surplus or reserves in a balance-sheet has no relation to amounts of cash available nor does it necessarily suggest that a dividend can be paid.

13. Footnotes are an integral part of financial statements and include important information for the investor.

14. The report of the independent auditor, which accompanies most published financial statements, expresses his *professional opinion* as to whether or not the statements adequately present the earnings and the status of the company in accordance with accepted accounting principles consistently applied.